FINANCE AND ECONOMICS

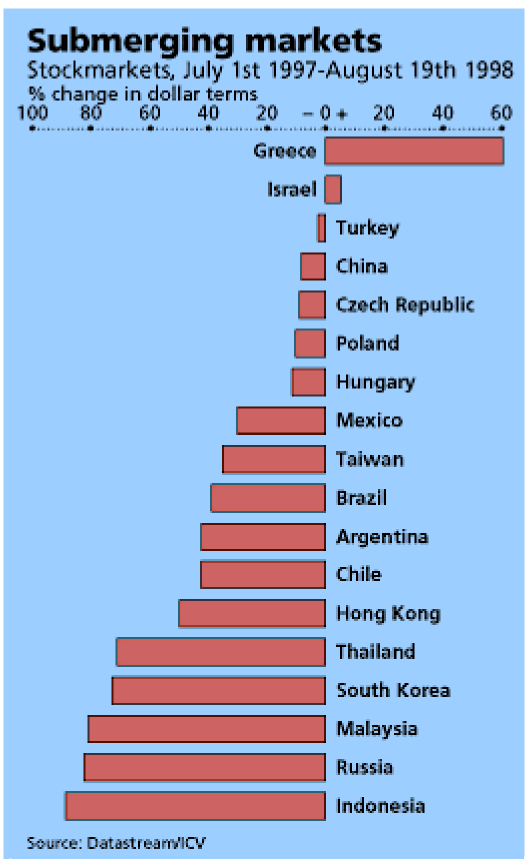
Emerging-market measles

FURTHER READING

Search archive

A CONTAGIOUS disease continues to spread through emerging markets. After the Thai baht was devalued in July 1997, stockmarkets and currencies tumbled across Asia. Several Latin American markets then caught a nasty chill. And now turmoil in Russia is sending shivers through almost every emerging market.

The IFC index of emerging stockmarkets has fallen by 19% in dollar terms over the past month, leaving share prices at barely half their level in July last year. Only Greece and Israel have seen gains in share prices over the past year (see chart). Bond prices have also tumbled, pushing up the average yield on emerging-market government bonds to nine percentage points over the yield on American Treasury bonds, compared with a five-point spread at the start of the year.



Markets are already trying to guess which economy will be next to devalue its currency. Following the example of Asia, where crisis spread first from Thailand to its neighbours, one might expect the East European currencies and stockmarkets to be favourites to plunge in the rouble's wake. Yet Latin American stockmarkets have actually fallen more sharply, by around 40% over the past year, compared with an average drop of only 10% in Eastern Europe. This seems unfair, given that the Latins have few trade or financial links with either Asia or Russia. However, the various channels of contagion are more complicated.

The most obvious way in which problems can spread from one emerging market to another is through trade. Countries lose competitiveness when their trading partners devalue. This was important in East Asia, where well over half of most countries' exports go to the rest of Asia (including Japan). Russia, in contrast, is no longer an important export market for most East European countries, so the risk of regional contagion is small. Exports to Russia from the Czech Republic, Hungary and Poland accounted for less than 5% of their total exports in 1997, or only 1-2% of their GDP. Ukraine, on the other hand, exports almost 10% of its GDP to Russia. Ukraine's currency, the hryvnia, has already sunk to the bottom of its trading band against the dollar.

But why have the Latin markets been savaged, even though their trade with Asia and Russia is modest? Enter the second link in the transmission of Asian flu: commodity prices. The East Asian countries are big importers of raw materials, so the slump in their economies has pushed down the prices of oil and other commodities such as metals and timber. The slide in prices has been exacerbated by fears that Russia will now boost its exports of raw materials.

Oil prices have fallen by a third since last July, and *The Economist*'s industrial commodities price index is down by a quarter. This has been painful for Latin America, because raw materials account for almost half the region's exports.

The third channel through which the emerging-market disease spreads is the reduction in investors' appetite for risk following the crises in Asia and Russia. This has prompted a general shift of money out of emerging-market funds into safer havens, such as American Treasuries. But that shift has not been completely indiscriminate. In general, economies that share some of the same weaknesses as those in Asia or Russia have suffered most. Latin America compares badly with Eastern Europe on several economic indicators.

Like Asia, many Latin economies have large current-account deficits. J.P. Morgan expects Latin America to run an average current-account deficit of 4.2% of GDP this year, compared with an average deficit of 2.5% in Eastern Europe. Furthermore, the Latin American economies have huge foreign debts, amounting to around 300% of exports in Brazil and Argentina, compared with an average of less than 100% in Eastern Europe.

Brazil shares another economic problem with Russia: a huge budget deficit, forecast to be 7% of GDP this year, even bigger than Russia's 6%. In contrast, the governments of most East European countries run fairly modest defects.

Thus, while most emerging markets have suffered heavy losses, it is unfair to say that they have all been tarred with the same brush. The contagion has been more severe in Latin America because most Latin countries are big commodity producers and some of their economies are far from sound. This is why Brazil's stockmarket has been hurt more than Poland's—and why its currency may well be next in the firing line.